FILE COPY

Office Supreme Court
FILED
JAN 31 19

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1935

No. 610

NORFOLK AND WESTERN RAILWAY COMPANY,
Appellant

v.

STATE OF NORTH CAROLINA, on Relation of
A. J. MAXWELL, Commissioner of Revenue

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF NORTH CAROLINA

BRIEF AND ARGUMENT FOR APPELLANT

THEODORE W. REATH
F. M. RIVINUS
W. W. COXE
MURRAY ALLEN
BURTON CRAIGE
Counsel for Appellant

INDEX

PAGE

OPINION OF COURT BELOW 1

STATEMENT OF JURISDICTION 2

STATEMENT OF THE CASE 2

(a) The State Income Tax Statute 3
(b) The Proceedings in the State Courts 4
(c) The Facts 6

SPECIFICATION OF ERRORS 11

SUMMARY OF ARGUMENT 15

ARGUMENT:

I. In an income tax case where the taxpayer's constitutional right depends upon ascertainment of net income earned within the State, the taxpayer is entitled as matter of law to specific findings of fact with regard to statutory gross operating revenues within the State and operating expenses attributable to the earning of such gross revenues 16

II. The evidence for the State setting up methods of arriving at gross operating revenues within the State is irrelevant to any issue under the statute, and even if regarded as relevant, is insufficient 24

III. The State income tax statute applied to the relevant and established facts of the present case violates the Commerce Clause of the Federal Constitution as imposing a burden upon Interstate Commerce, and the due process clause of the Federal Constitution as imposing a tax upon the result of operations outside and beyond the reach of the state taxing power 33

TABLE OF CASES

PAGE

Atlantic Coast Line R. Co. *v.* Daughton, 262 U. S. 413 ..... 16, 26

Board of Commissioners Boone Co. *v.* Adler, 133 N. E. 602 26

Commonwealth *v.* Lorillard, 129 Va. 74 25

Crowell *v.* Benson, 285 U. S. 22 23

Hans Rees Sons *v.* North Carolina, 283 U. S. 123 . 27, 41

Maxwell Commissioner *v.* Kent-Coffey Mfg. Co., 204 N. C. 365 ..... 34, 41

Preston *v.* Sturgis, 183 Fed. 1 25

Southern Ry. Co. *v.* Kentucky, 274 U. S. 76 38

Stewart Dry Goods Co. *v.* Lewis, 294 U. S. 550 42

Thompson *v.* Smith, 156 N. C. 345 22

Underwood Typewriter Co. *v.* Chamberlain, 254 U. S. 113 41

Union Tank Line Co. *v.* Wright, 249 U. S. 275 ... 27, 37

Wallace *v.* Hines, D. G. 253 U. S. 66 39

STATUTES CITED

N. C. Revenue Acts:

Sec. 312, Chap. 80, Public Laws, 1927 ..... 3, 11, 12

Sec. 312, Chap. 345, Public Laws, 1929 ..... 3, 11, 12

(N. C. Code 1931, Michie, Sec. 7880 [130])

N. C. Code 1931, Michie, Sec. 7880 (153) 4-5

N. C. Code 1931, Michie, Sec. 7880 (156) 5

N. C. Code 1931, Michie, Sec. 573 6

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1935

NORFOLK AND WESTERN RAILWAY COMPANY,
Appellant
v.
STATE OF NORTH CAROLINA, on Relation of A. J. Maxwell, Commissioner of Revenue,
Respondent

No. 610

ON APPEAL FROM THE SUPREME COURT OF THE STATE OF NORTH CAROLINA

BRIEF AND ARGUMENT FOR APPELLANT

REFERENCE TO REPORT BELOW

The opinion of the State Supreme Court is reported as State of North Carolina ex rel A. J. Maxwell, Commissioner of Revenue *v.* Norfolk and Western Railway Company, 208 N. C. 397. The case is also reported in 181 S. E. 248.

STATEMENT OF JURISDICTION

Rule 12, Paragraph 1, has been complied with upon the presentation of the petition for allowance of this appeal to the Chief Justice of the Supreme Court of North Carolina. This Court on December 23, 1935, ordered that further consideration of the question of jurisdiction be postponed to the hearing of the case on the merits. For the jurisdiction of this Court reliance is placed upon the Statement of Jurisdiction on Appeal and Brief Opposing Motion to Dismiss or Affirm hereinbefore filed in this Court with the record and printed by the Clerk of this Court.

STATEMENT OF THE CASE

This suit was brought by the Railway Company in the Superior Court of Wake County, North Carolina, for recovery of income taxes assessed and paid by the Railway Company under the State income tax law. The suit is specifically authorized by State statute. Under the State practice the suit was referred to a Referee, who heard the testimony and argument and reported his Findings of Fact and Conclusions of Law to the Superior Court; they were in favor of the Railway Company and for recovery of the tax paid. On exceptions of the State, the Court refused to accept the Referee's conclusions and entered judgment in favor of the State denying recovery. On appeal by the Railway, the Supreme Court of North Carolina entered judgment, final under the State law, affirming the judgment of the Superior Court. This appeal is prosecuted from the final judgment of the Court of last resort of the State.

(a) The State Income Tax Statute

North Carolina Revenue Acts, Section 312, Chap. 80, Public Laws 1927, and Section 312, Chap. 345, Public Laws 1929 (North Carolina Code 1931, Michie, Sec. 7880 [130]), both of which Sections 312 are in substantially the same words, prescribe the method of ascertaining the "net revenue" for income tax of railroads which operate within and outside the State. The text follows:

"Section 312. Railroads and public service corporations.

"The basis of ascertaining the net income of every corporation engaged in the business of operating a steam or electric railroad, express service, telephone or telegraph business, or other form of public service, when such company is required to keep records according to the standard classification of accounting of the Interstate Commerce Commission, shall be the 'net operating income' of such corporation as shown by their records kept in accordance with that standard classification of accounts, when their business is wholly within this State, and *when their business is in part within and in part without the State their net income within this State shall be ascertained by taking their gross 'operating revenues' within this State, including in their gross 'operating revenues' within this State the equal mileage proportion within this State of their interstate business and deducting from their gross 'operating revenues' the proportionate average of 'operating expenses,' or 'operating ratio,' for their whole business, as shown by the Interstate Commerce Commission standard classification of accounts.* From the net operating income thus ascertained shall be deducted 'uncollectible revenue' and taxes paid in this State for the income year, other than

income taxes, and the balance shall be deemed to be their net income taxable under this act. That in determining the taxable income of a corporation engaged in the business of operating a railroad under this section, in the case of a railroad located entirely within this State, the net operating income shall be increased or decreased to the extent of any credit or debit balance received or paid, as the case may be, on account of car or locomotive hire; and when any railroad is located partly within and partly without this State, then said net operating income shall be increased or decreased to the extent of an equal mileage proportion within this State of any credit or debit balance received or paid, as the case may be, on account of car or locomotive hire."

(Italics supplied to indicate language to be considered here:)

(*b*) *The Proceedings in the State Courts*

In compliance with this statute the Railway Company made returns in due time for the years 1927, 1928 and 1929 to the Commissioner of Revenue. The returns showed as gross operating revenue within the State a figure computed by an approximate method to produce equal mileage proportion within the State of the revenues of the Railway Company, which operates lines both inside and outside the State. From the gross operating revenue so computed the Railway Company deducted, in order to find net income within the State, the estimated expenses attributable to operation within the State. The State expenses exceeding the gross operating revenues within the State, no tax was tendered. Thereafter, October 27, 1930, the Commissioner of Revenue made reassessment against the Railway Company, N. C. Code

1931, Michie, §7880 (153), accepting and adopting the figure of gross operating revenue within the State as shown in the original returns of the Railway Company, but deducting from the figure of gross operating revenue a sum to represent operating expenses measured by the operating ratio of the Railway Company for business of its entire system within and outside the State. By the application of the system operating ratio to the North Carolina gross revenues, the Tax Commissioner produced a figure alleged to represent net income within the State of North Carolina, and made demand upon the Railway Company for payment of income tax upon the basis of such alleged net income. Under protest duly filed, the amount so demanded was paid as follows:

For the year 1927 as tax on alleged income	$25,737.70	
Plus Interest	3,989.34	$29,727.04
For the year 1928	$25,097.32	
Plus Interest	2,384.25	27,481.57
For the year 1929	$28,225.22	
Plus Interest	987.88	29,213.10
Amount paid under protest		$86,421.71

The protest having been overruled after hearing by the Commissioner, the Railway Company prosecuted appeal to the Superior Court of Wake County, North Carolina, as provided by the statute (N. C. Code 1931, Michie, Sec. 7880 [156]) for recovery of the amount paid as illegally assessed. The case was referred by the Superior Court to Hon. J. Crawford Biggs, as Referee

(N. C. Code 1931, Michie, Sec. 573), was heard before him and resulted in report (Record p. 73) based on findings of fact, to which the State took exception. The Referee "concludes that the Railway Company is entitled to recover from the State the amounts paid by it as income taxes" in each of the years sued for, with interest from the date of payment. The Referee's report was overruled by the Superior Court, judgment was entered for the State and appealed by the Railway Company to the Supreme Court of the State. That Court affirmed the judgment with opinion (Record p. 839).

(c) *The Facts*

In fact and in law this case is disclosed by the above quoted text of the statute, the Findings of Fact and Conclusions of Law of the Referee (Record p. 73), the Findings of Fact and Judgment of the Superior Court (Record p. 145) and the opinion of the State Supreme Court (Record p. 839).

No question was raised at the outset of the case (in the Commissioner's reassessment) nor is any question presented now of ascertainment under the statute of the equal mileage proportion within the State of gross operating revenues. In overruling the Railway protest the Commissioner said: "The statute has been followed in setting up gross revenues." Further the Commissioner admitted that his reassessment of income tax against the defendant had been made after careful analysis of the defendant's returns and audit of its accounts by a representative of the State Department of Revenue. Later, however, at the hearing before the Referee, the State's witness, J. W. Roberts, criticized the accuracy of the approximate me-

thod of computing gross revenues. Thereupon the Railway calculated the equal mileage proportion of gross revenues attributable to the State in exact compliance with the statute, and substituted the figure so ascertained for the approximate gross previously returned: Vaughan, recalled (Record pp. 635–636): Vaughan substituted Exhibit B (Record pp. 662–673). There was no further testimony on the subject and the substituted figure was found to be in fact correct by the Referee: Finding 1 (Record p. 76). And in the "Findings of Fact and Judgment" of the Superior Court reviewing the Referee's report, the Trial Judge says (Record p. 147):

> "No question is raised respecting the correctness of the Commissioner's method of computing the gross 'operating revenues' of the defendant Railway Company under the statute in question;"

From the text of the statute this Court has seen that the statute assumes that the "operating ratio" of the entire railroad system in and outside the State is a measure for ascertainment of net income derived from gross income within the State. To illustrate by simplified figures: If the gross operating revenues of the entire system are $100,000,000, and the system operating expenses are $60,000,000, the operating ratio is 60%, that is, it takes 60 cents in expense to earn every dollar over the system, and the remaining 40 cents is net operating revenue. Now if $1,500,000 of the system gross is earned on that part of the branches in North Carolina, the statute assumes by application of the system ratio that 40% of this State gross represents net operating income earned and taxable within the State.

The Railway undertook the burden of showing that in its particular case, and because of its peculiar geographical position with only relatively thin-traffic branch lines entering the State, the statutory assumption of average net income is unjustified and does not produce even approximately accurate results. To sustain its burden the Railway produced and compared the figures of traffic density within and outside the State, of gross revenues within and outside the State, and of operating expenses attributable to the earning of the gross revenues within the State; and proved to the satisfaction of the Referee that the expense of earning the North Carolina gross revenues is substantially greater than the system ratio: Referee's report, Finding No. 2, Record p. 77.

Before the Referee the State admited that the operating expenses of the Railway's branch lines entering the State are higher than is indicated by the statutory formula. Thus J. W. Roberts, the State's sole witness on this point, alluding to the testimony of the Railway witnesses, Vaughan and Conrad, on the operating expenses of the North Carolina branches, said (Record p. 464):

> "I think their figures may be accepted at face value without being seriously misleading as respects the relation of operating expenses on the branch lines to those on the main lines of the system. On a unit basis, the branch line expenses are unquestionably the higher, principally due to relatively lighter traffic density, and operating obstacles in the way of grades and curves, which are excessive on the branches as compared with the balance of the system."

Again (Record p. 487) he alludes to "higher operating costs experienced on the branch lines." At Record p. 545, he mentions "the high costs of operation on the branch

lines serving North Carolina," etc. And, finally (Record p. 614), he admits that "it has been shown that the branch line expenses are relatively higher than the average for the system," etc.

Thereupon the Referee found upon proofs which are undisputed in the record and admitted by Roberts that:

> "the expense of conducting that part of its business which is done in North Carolina is substantially greater in proportion to the gross operating revenues of the Railway Company in the State than the system ratio of Operating Expenses to Operating Revenues in the years in question": Referee's Finding No. 2 (Record p. 77).

Detailed findings of fact were made by the Referee in support of his ultimate finding that the North Carolina ratio of expense to revenue is greater than the system ratio. These supporting findings establish the geographical, operating and accounting facts of the case, are set out in the Referee's report (Record pp. 73–91) and need not be transcribed here; they were (in part at least) affirmed by the Superior Court.

The State's theory of defense, based on the testimony of Roberts, is that the Railway actually earns more gross revenue in North Carolina than is shown by the statutory equal mileage proportion of gross revenue. Thus Roberts testified (Record p. 463):

> "Freight rates lawfully assessed by the Railway for transporting freight over the branch lines serving North Carolina are on a much higher level than rates assessed for the same quantity and quality of service on other portions of its system."

And he goes on in his testimony to argue that if the Railway is permitted to show the expense of earning the

North Carolina gross, then the State should be permitted to show *actual* gross revenue from an alleged higher rate level, rather than accept the equal mileage prorate specified by the statute.

So the case for the State in perspective amounted to this: The Railway having shown (and the State by its sole witness having admitted) that the North Carolina ratio of expenses to earnings (apportioned as the statute directs on equal mileage basis) is greater than the system ratio of expenses to earnings, the State undertook to show that there may be net earnings in some amount if the statutory formula of equal mileage apportionment of gross revenues be abandoned. Later in the argument the impossibility of proving a difference of rate levels (if there be a difference) within and outside North Carolina will be shown. For the present it is noted that the clear, specific statutory formula was altogether abandoned by the State, and effort was made to show net income by some other than the statutory method.

Overruling the Referee's conclusion that the Railway should recover the taxes paid under protest, the Superior Court adopted the theory of the State, without, however, finding facts upon which the assessment could be based. The Superior Court found (as had the Referee) certain of the primary facts indicating that the ratio of operating expenses to gross earnings in North Carolina is greater than the ratio of operating expenses to gross earnings over the Railway's entire system in and out of the State; but the Court surmised that (Record p. 151):

> "The evidence seems persuasive that if the *actual* gross operating revenues should be determined the amount returned by the defendant would be

increased by a much greater proportion than the operating expenses in North Carolina are increased over the operating expenses determined by the use of the statutory formula." (Italics ours.)

The Supreme Court of the State affirmed the judgment in favor of the State, saying, erroneously as we shall point out, that the Superior Court had "found supporting facts," etc. The State Supreme Court treated the case as one in which there was conflict of testimony upon issues, the determination of which lay within the statute and the final jurisdiction of the Trial Judge. In this Court, as in the Courts below, counsel for the Railway Company will seek to demonstrate that there was no dispute of fact upon any material issue, that the material findings of the Referee were in fact undisputed, substantially admitted by the State, and that judgment denying recovery is based upon a theory which disregards the State tax statute and surmises the existence of taxable income in some amount not less than the amount the Railway Company was required to pay. In this way the constitutional rights of the taxpayer were ignored as the result of an erroneous theory unfounded on the statute or in fact, with resulting burden upon interstate commerce and taking of property of the taxpayer without due process of law.

SPECIFICATION OF ERRORS

Norfolk and Western Railway Company assigns the following errors in the record and proceedings in the said cause:

I. The Supreme Court of North Carolina erred in refusing to find Section 312 of North Carolina Revenue Act

of 1927 and the same numbered section of the Revenue Act of 1929 (which is in substantially the same words) unconstitutional and repugnant to the due process clause of the Fourteenth Amendment to the Constitution of the United States, because, by the use, for ascertainment of net income taxable in North Carolina, of the ratio of operating expenses to gross operating revenues of the entire system of appellant, these sections assume, contrary to the fact established in the record, that the ratio between operating expenses and gross operating revenues of appellant's North Carolina branch lines approximately equals the same ratio for appellant's entire system, including main line which nowhere enters the State, thereby imposing arbitrary and unreasonable taxes upon appellant and taking its property without due process of law.

II. The Supreme Court of North Carolina erred in refusing to find Section 312 of North Carolina Revenue Act of 1927 and the same numbered section of the Revenue Act of 1929 (which is substantially in the same words) unconstitutional and repugnant to the commerce clause, Section 8 of Article I of the Constitution of the United States, because, by the use, for ascertainment of net income taxable in North Carolina, of the ratio of operating expenses to gross operating revenues of the entire system of appellant, these sections assume, contrary to the fact established in the record, that the ratio between operating expenses and gross operating revenues of appellant's North Carolina branch lines approximately equals the same ratio for appellant's entire system, including main line which nowhere enters the State, thereby imposing unreasonable and unconstitutional burden upon interstate commerce as conducted by appellant.

III. The Supreme Court of North Carolina erred in adopting the findings of fact made by the Judge of the Superior Court of Wake County as basis for the conclusion of law that appellant has not been deprived of rights guaranteed by the Fourteenth Amendment to the Constitution of the United States because such findings are:

(a) Contrary to the admissions of the State in the record; and

(b) Unsupported by evidence.

IV. The Supreme Court of North Carolina erred in affirming the judgment of the Superior Court of Wake County, North Carolina, and in refusing to reverse said judgment upon the following grounds:

(a) In that the said Superior Court overruled, by implication at least, the specific findings of fact of the Referee to whom the case had been referred under State law. These findings were numbered by the Referee Nos. 1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11 and 12; they are based upon uncontradicted facts appearing in the record, admitted by the sole witness for the State, and furnished the sole basis for correct conclusions as to the exact nature of appellant's business and the expense of conducting it within and outside the State.

(b) In that, in this State income tax proceeding, where the appellant's constitutional right depends upon ascertainment of net income earned within the State, the appellant as taxpayer is entitled as matter of law to specific findings of fact with regard to statutory gross income within the State and with regard to operating expenses attributable to the earning of such gross income. The said Superior Court of Wake County made neither of these essential findings and made in fact no findings upon which to

base the judgment here complained of. There is nothing in the judgment of the said Superior Court to support the opinion of the Supreme Court of North Carolina that the said Superior Court "found supporting facts" for the conclusion of law complained of.

(c) In that the Superior Court of Wake County admitted and gave controlling effect, over appellant's objection, to testimony of the State's sole witness that "the high costs of operation on the branch lines serving North Carolina have also been recognized in fixing the levels of commodity rates applicable over the branches" (Record, p. 545, Objection, p. 627, and Assignment, p. 821); and that: "Freight rates lawfully assessed by the Railway for transporting freight over the branch lines serving North Carolina are on a much higher level than rates assessed for the same quantity and quality of service on other portions of its system" (Record, p. 463, Exception, p. 623, Assignment, p. 817). The ground of this subdivision (c) of assignment is that the testimony quoted is irrelevant to any of the issues made in the case, represents the witness' opinion and is unsupported in the evidence; and is irrelevant to the statutory formula prescribed for the ascertainment of the factor of gross income in the computation of net taxable income.

(d) That the Superior Court of Wake County gave decisive effect to the testimony last quoted in irrelevant finding that the appellant's North Carolina branch lines operate in territory having relatively high rate levels, and in concluding with the supposition (as distinguished from fact finding) "that if the actual gross operating revenues should be determined the amount returned by the defendant would be increased by a much greater proportion than the operating expenses in North Carolina are

increased over the operating expenses determined by the use of the statutory formula." (Record, p. 151, Assignment, p. 830). The ground of this assignment is that the quoted language of the Superior Court, if regarded as a finding of fact, is unsupported by evidence, is supposititious, is irrelevant to any issue made in the case and disregards the statutory formula for ascertainment of the factor of gross income.

(e) That the Superior Court of Wake County, North Carolina, refused to find the facts of statutory gross and of deductible expenses from which alone the existence of net income in North Carolina could be determined.

The specific errors hereinabove assigned have demonstrably resulted in violation of the due process clause of the Fourteenth Amendment and of Section 8 of Article I of the Constitution of the United States.

SUMMARY OF ARGUMENT

I

IN AN INCOME TAX CASE WHERE THE TAXPAYER'S CONSTITUTIONAL RIGHT DEPENDS UPON ASCERTAINMENT OF NET INCOME EARNED WITHIN THE STATE, THE TAXPAYER IS ENTITLED AS MATTER OF LAW TO SPECIFIC FINDINGS OF FACT WITH REGARD TO STATUTORY GROSS OPERATING REVENUES WITHIN THE STATE AND OPERATING EXPENSES ATTRIBUTABLE TO THE EARNING OF SUCH GROSS REVENUES.

II

THE EVIDENCE FOR THE STATE SETTING UP METHODS OF ARRIVING AT GROSS OPERATING REVENUES WITHIN

THE STATE IS IRRELEVANT TO ANY ISSUE UNDER THE STATUTE, AND EVEN IF REGARDED AS RELEVANT, IS INSUFFICIENT.

III

THE STATE INCOME TAX STATUTE APPLIED TO THE RELEVANT AND ESTABLISHED FACTS OF THE PRESENT CASE VIOLATES THE COMMERCE CLAUSE OF THE FEDERAL CONSTITUTION AS IMPOSING A BURDEN UPON INTERSTATE COMMERCE, AND THE DUE PROCESS CLAUSE OF THE FEDERAL CONSTITUTION AS IMPOSING A TAX UPON THE RESULT OF OPERATIONS OUTSIDE AND BEYOND THE REACH OF THE STATE TAXING POWER.

ARGUMENT

The argument will proceed under the heads indicated in the preceding Summary.

I

IN AN INCOME TAX CASE WHERE THE TAXPAYER'S CONSTITUTIONAL RIGHT DEPENDS UPON ASCERTAINMENT OF NET INCOME EARNED WITHIN THE STATE, THE TAXPAYER IS ENTITLED AS MATTER OF LAW TO SPECIFIC FINDINGS OF FACT WITH REGARD TO STATUTORY GROSS OPERATING REVENUES WITHIN THE STATE AND OPERATING EXPENSES ATTRIBUTABLE TO THE EARNING OF SUCH GROSS REVENUES.

(*Specification of Errors IV, Record, p. 845-6.*)

In a case in which this Court considered the North Carolina income tax legislation, out of which the present case also arises, Atlantic Coast Line R. Co. *v.* Daughton,

262 U. S. 413 (67 L. Ed. 1051) at p. 422, Mr. Justice Brandeis observed:

> "The term 'net income,' in law or in economics, has not a rigid meaning. Every income tax act necessarily defines what is included in gross income; what deductions are to be made from the gross to ascertain net income; and what part, if any, of the net income, is exempt from taxation."

The Act under examination makes the necessary definitions: (1) of gross income—"gross operating revenues within this State, including in their gross operating revenues within this State the equal mileage proportion within this State of their interstate business," etc.; (2) of deductions to be made from the gross to ascertain net income—"deducting from their gross operating revenues the proportionate average of operating expenses, or operating ratio for their whole business," etc.; and (3) the remainder is the net income taxable under the statute.

The Railway Company insists that it is entitled as a matter of legal right to clear, specific findings (1) of gross, (2) of allowable deductions (in this case "operating expenses") and (3) of resulting taxable net, if any. These findings are necessary in a case like this for preservation of the constitutional rights of the taxpayer. And the Referee made all these necessary findings, clearly, specifically and with detail of supporting fact from undisputed and admitted evidence in the record:

(1). Of gross income in the State—See Referee's Finding No. 1, Record p. 76.

These figures are:

For 1927.....	$1,579,850.54
For 1928.....	1,437,861.41
For 1929.....	1,410,818.36

(2). Of allowable deductions of "operating expenses"—See Referee's Finding No. 11, Record p. 81.

These figures are:

For 1927.....	$1,520,935.32
For 1928.....	1,455,623.74
For 1929.....	1,444,704.56

(3). Of the remainder or taxable net income under the statute, the Referee finds (Finding No. 11):

"For the years 1928 and 1929 these figures" (that is, allowable deductions from gross) "excluding taxes, are in excess of the North Carolina gross revenues ascertained in the method prescribed by the statute, and for the year 1927, including taxes, are in excess of such revenues."

Now, what did the Superior Court do with these findings in reversing the Referee and upon what substituted findings did that Court base its judgment for the State? As to gross income the Trial Judge observed:

"3. No question is raised respecting the correctness of the Commissioner's method of computing the gross 'operating revenues' of the defendant Railway Company under the statute in question;" etc. (Record p. 147).

Again he found:

"7. In making the returns the defendant used the statutory formula for determining gross operating revenues," etc. (Record p. 151.)

But he also found, on evidence which, as will be argued later, was irrelevant to any issue framed in the case or presented under the statute, the existence of a higher

rate level on the North Carolina branches than exists over the rest of the Railway system outside the State; and, disregarding the admission of the Revenue Commissioner, disregarding the statutory mandate for ascertainment of State gross and disregarding the Referee's finding, he says:

> "The evidence seems persuasive that if the *actual* gross operating revenues should be determined the amount returned by the defendant would be increased by a much greater proportion than the operating expenses in North Carolina are increased over the operating expenses determined by the use of the statutory formula." (Record p. 151.) (Italics ours.)

So, with no more than a finding of higher rate level in North Carolina (later it will be noticed that rate level is inconclusive without findings of how much is carried under the higher rates and how much the carrier gets out of the rates), the Trial Judge concludes:

> "These results demonstrate the contention of the plaintiff that his use of the statutory formula in determining both gross revenue and operating expenses of the defendant for the years involved in this action does not work an unconstitutional or unreasonable burden upon the defendant."

There is here no finding of gross income to be substituted for the Referee's specific finding, no more than a persuasion that if a supposed "actual" gross should be determined, it would be greater in some undisclosed amount than the gross admittedly ascertained in accordance with the statute. And the statutory gross is accordingly discarded together with the statute. Without supporting evidence, without statutory authority and with-

out even a substitute finding, the Referee's specific finding of admitted statutory gross is overruled as inconsistent with the court's persuasion.

As to allowable deductions or "operating expenses" there is no dispute of fact in this record. The State did not question the Railway figures of expense attributable to the earning of the North Carolina gross. Roberts, the sole witness for the State, admitted them (Statement of the Case, *supra* p. 2); the Referee found them specifically in dollars to be greater than the State gross, and the Trial Judge found:

> "The unit cost of transportation in North Carolina is greater than the average on the remainder of the system; but the evidence is not conclusive as to what extent this inequality of cost obtains."

Just what is meant by the apparent qualification in the last half of this sentence is not clear. The Railway Company was under no legal burden to produce "conclusive" evidence. If there had been any conflict of evidence on the point, a preponderance one way or the other would have been enough. But there was no conflict. The evidence was all one way and was specific, in dollars and cents. The Referee could not have found otherwise than he did; and the court had no justification in casting doubt on the finding. Moreover, as has been seen, the "extent" of this inequality of cost is apparent from the uncontradicted finding in dollars and cents of the very amount of cost of earning the State gross. (Referee, Finding No. 11, Record p. 81.)

For the rest, mere subtraction of definitely ascertained operating expenses from the State gross shows

absence of net income for taxation—in earning the State gross, the Railway Company operated in the red. There could be no tax, for there was no net income. But here again, although the Superior Court affirms assessment of a tax of $86,421.71, there is no finding (except by inference) of the net income on which the tax is assessed. This Court will observe that the amount of the tax is computed by application of the system ratio to the State gross in accordance with the statutory formula. But the State in effect has conceded that the statutory formula produces unreality. The State's theory of the case is expressed and upheld in the trial Judge's observation "that if the *actual* gross operating revenues should be determined the amount returned by the defendant would be increased by a much greater proportion than the operating expenses in North Carolina are increased over the operating expenses determined by the use of the statutory formula." It was the duty of the trial Judge to find this "actual" gross figure, which he here indicates clearly enough has not been determined. And we shall see later on that it cannot be determined from this record. Nevertheless the trial Judge sustains a tax assessment based not upon this so-called "actual" gross, but upon the statutory gross, that is, gross ascertained by the statutory mileage prorate method. And the net income upon which the tax is assessed is produced by application of the system ratio which the State, the Railway Company, the Referee and the trial Court all agree produces unreality as applied to the recorded facts in this case.

The practical necessity of specific findings in a case like this, if constitutional rights are to be preserved, is recognized in the established practice of the State. The

decisions of the State Supreme Court with regard to exceptions to the report of a Referee are clear and specific. In Thompson *v.* Smith, 156 N. C. 345, 72 S. E. 379, the Court said:

> "When exceptions are taken to a Referee's findings of fact and law, it is the duty of the Judge to consider the evidence and give his own opinion and conclusion, both upon the facts and the law. He is not permitted to do this in a perfunctory way, but he must deliberate and decide as in other cases—use his own faculties in ascertaining the truth and form his own judgment as to fact and law. This is required not only as a check upon the Referee and a safeguard against any possible errors on his part, but because he cannot review the Referee's findings in any other way."

It is true, speaking generally, that State practice and procedure is not of Federal concern—the clear-headed State practice, disregarded in this case, is mentioned only as recognition by the State Court of the practical necessity of definite rulings on issues of fact if rights of any sort are to be preserved.

Where the issue is of the existence of taxable net income, as in this case, the taxpayer is entitled to specific findings by the trial Court as basis for the tax and when the Referee has specifically found facts both as to gross income and as to deductible expenses, that Court cannot properly set aside such findings without substituting specific findings in their place. This is the only way by which the rights of the taxpayer may be preserved against invasion by the taxing authorities of his statutory and constitutional rights. In the North Carolina Courts the Railway Company, the Referee's definite relevant find-

ings were either overruled or given no effect and the assessment was sustained without findings. The rule that this Court will make its own findings is vital to Constitutional right in this case: Crowell *v.* Benson, 285 U. S. 22; 76 L. Ed. 598.

True, the trial Judge affirmed findings of fact and conclusions of law of the Referee "not inconsistent" with his order. But it is impossible to say confidently just what findings of the Referee the trial Judge intends to overrule as inconsistent therewith. Specifically, the trial Judge does find greater traffic density per mile of road outside North Carolina than on the branch lines within the State and that there are "greater grades in North Carolina and more curves than throughout the system on an average," etc. (Record, p. 150). These findings point to the conclusion of the Referee that operating expenses of earning State gross revenue are relatively higher than would be indicated by application of the system ratio. But such affirmed findings have no significance if the trial Judge is free to offset their effect by a persuasion unsupported in fact that gross revenues are greater in some unascertained and unascertainable amount than the gross revenues computed in accordance with the statute. It is plain that all of the Referee's specific findings are emptied of value if the trial Judge is permitted to guess that "actual" gross operating revenues if ascertained (as they were not in this case) would be so increased by abandonment of the statute as to result in net income sufficient to justify the tax assessed under the discarded statutory formula.

The State Supreme Court simply assumed that the Superior Court had "found supporting facts" and for the rest commented upon the conclusiveness of that Court's

findings when supported by evidence. But as we have observed, there were no facts to support the judgment, only an erroneous theory of law based on surmise of unproved and (as we shall see) unprovable facts.

II

THE EVIDENCE FOR THE STATE SETTING UP METHODS OF ARRIVING AT GROSS OPERATING REVENUES WITHIN THE STATE IS IRRELEVANT TO ANY ISSUE UNDER THE STATUTE, AND EVEN IF REGARDED AS RELEVANT, IS INSUFFICIENT.

(*Specifications of Errors III, Record p. 845*)

The irrelevancy of the Roberts' evidence to any issue framed for hearing before the Referee or presented by the statute has been noticed. Roberts concedes that the operating expenses of the Railway Company attributable to earning of the statutory mileage prorate of gross revenues are, as the railroad proofs showed, substantially greater than the figures ascertained by application of the system ratio as representing operating expenses of earning State gross. Such admission seems conclusive against the Commissioner's assessment. But the witness, Roberts, in his testimony (Record p. 463) argues as follows:

> "If a test is to be made of the reasonableness of the statutory formula's use of the system operating ratio, that ratio must be applied to *Actual Gross Revenue* (not a mileage prorate of system gross revenue) to produce an operating expense factor which is comparable with *Actual Operating Expenses* in the state. Our ratio would then be,
>
> Actual Expense: Actual Gross Revenue. The Railway's witness would use the ratio,

Actual Expense: Averaged Gross Revenue
Whereas the statutory formula employs the ratio,
Averaged Expense: Averaged Gross Revenue."

Whatever this argumentative witness means, he is evidently out to rewrite and remodel the statute. "Our ratio" (that is, the ratio of this resourceful witness) is contrasted with and substituted for the statutory formula. It was in the State Courts in effect argued for the State that if the Railway may overthrow, as unreal and substantially prejudicial to it, the statutory formula for ascertaining expense by employment of the system ratio, then the State may abandon the statutory formula for ascertaining gross revenue (equal mileage proportion) as unreal and prejudicial to the State. Because the Railway can demonstrate that employment of the system ratio, which includes the effect of great main line operations which never touch the State, is irrelevant and does not approximate the North Carolina reality, the State may not baldly abandon the statute and impose upon the Railway the burden of negativing the existence of net income in North Carolina upon any theory devised by the State's expert witness.

The power of taxation is legislative and not administrative or judicial, particularly here where the statutory formula is clear and specific. The power can be exercised only under legislative authority. "Each step in the process of taxation from beginning to end can be taken only as the legislature may prescribe:" Preston *v.* Sturgis, 183 Fed. 1 (C. C. A.), 32 L. R. A., N. S. 1020. The case of Commonwealth *v.* Lorillard Co., 129 Va. 74, 105 S. E. 683, is a good illustration of the point. There a foreign corporation was assessed for income tax under

the Virginia law of 1916. The Virginia statute did not provide any method for apportioning the amounts of income derived from business done within and without the State. The administrative officers undertook to devise a scheme of apportionment. The Court held that to allow the administrative officers to adopt their own method for such determination would be to give them legislative, as distinguished from administrative, power,—citing cases to the point that taxes can only be assessed, levied and collected in the mode prescribed by express statutory enactment. It may be that the Legislature can confer such power, but not the Courts. In Board of Commissioners of Boone Co. *v.* Adler (Ind.), 133 N. E. 602, the Court said, among other things:

> "* * * the Legislature has the exclusive power to devise the plan of taxation; to prescribe the method by which property shall be listed and valued; * * * to designate the manner in which * * * the rates shall be fixed," etc.

As has been noticed above, this Court considering North Carolina tax income legislation in Atlantic Coast Line R. Co. *v.* Daughton, 262 U. S. 413, 422, 67 L. Ed. 1051, observes in common sense that "every income tax necessarily defines" the factors for computation of taxable net, that is, statutory gross and allowable deductions which produce the taxable net. The definition of these factors cannot be left to administrative officers; still less can they be permitted to find net income without even taking the trouble to find and disclose figures upon which their computation of tax is based, as was done in this case by the Commissioner and by the State Courts.

If, as in the Lorillard case, there is no statutory method, or as in this case, the statutory method is invalid as to the Norfolk and Western, the result is the same—there is no valid authority for the tax. Such was the result of Hans Rees' Sons *v.* North Carolina, 283 U. S. 123, 75 L. Ed. 879, where this Court decided in effect that the allocation formula provided by the statute had been shown to produce substantially unjust results to the taxpayer and to import into the State for taxation income not earned there.

Doubtless the State statute adopted the mileage unit for allocation of interstate gross revenues because of the impracticability of demonstrating (as this case in fact illustrates) that a given rate for through haul is earned proportionately more or less in North Carolina than elsewhere. The practical problem and its difficulties and the reasons for adoption of a unit or measure that will produce approximately true results are considered by this Court in Union Tank Line Co. *v.* Wright, 249 U. S. 275, 63 L. Ed. 602, a case which will be discussed and quoted later herein.

There is particular need for adoption of the mileage unit here where each shipment and each rate would otherwise have to be examined to ascertain, if possible, whether more or less gross revenue was earned in North Carolina than distance of haul would indicate. In fact, the witness, Roberts, constantly admits throughout his testimony that because of difference of classification, of ratings and because of lack of information as to the amount of traffic moving on particular rates, it is impracticable to determine the effect of the particular rates which he selects to demonstrate higher rate levels on the North Carolina branches.

Expressions to this effect are to be frequently found in his testimony. As a sample of his testimony along this line the following is quoted from Record, page 552, of his testimony where he admits it is:

> "* * * impossible for anyone, unless it be the Railway itself, to examine the many thousands of rates and ratings which, during the three years involved in this case, applied to the hundreds of thousands of consignments which moved through the various gateways and junctions of the Railway's lines and contributed to its gross earnings in North Carolina."

And he might have added, in experienced candor, the unknown factor (to him) of divisions between railroads of the revenue from the countless through rate hauls. His anti-statutory rate level theories about arriving at what he calls "actual" gross operating revenues are nowhere better answered than by his own words. He admits that it is impossible to determine separately the revenue that each and every rate earns on a shipment, but undertakes to set up his "actual" gross revenue theory in the face of his own admission of impracticability (Record p. 469):

> "Railway accounting and statistical practice presently disregards the specific source of revenue, that is, whether it is derived from class rates or commodity rates, and likewise fails to distinguish the tons or ton-miles moving under each kind of rates. Therefore, we have no definite information concerning the monetary importance of differences in ratings and class rate levels as they affect the *whole* of gross revenue. To give such matters adequate consideration is virtually impossible."

And again (Record p. 499):

> "It is not feasible to develop in an orderly and

precise fashion the facts which we need to know to determine the actual relationship between Actual gross earnings and the Actual expenses which earned them, which has made an issue in this case."

* * * * * *

"Any attempt to measure the relative altitudes of rates applicable to a particular section of a railroad encounters many difficulties, and chief among them is the paucity of statistical data reflecting the volume of movement and revenues derived from different kinds of traffic. In the absence of special studies which the railroads alone are in position to make, such attempts must fall short of being complete and satisfactory. Their incompleteness may result in their being misleading in some degree unless their purport and premises are fully understood. The greater variety of traffic, the many different systems and schedules of rates which relate thereto, and the almost innumerable movements, preclude the selection of any reasonable number of individual shipments for presentation as representative instances, because we have no means of being sure that they are in fact representative." (Record p. 501)

In the face of these admissions by the State's sole witness and expert, counsel for the Railway Company have to confess to this Court their difficulty in comprehending the argumentative testimony purporting to compare rate levels in and outside North Carolina, and the effect he gives them in determining "actual" gross revenues attributable to the State. The Railway rate witness, Keeley, thought that the Roberts thesis—that freight rates on the North Carolina branches "are on a much higher level than rates assessed for the same quantity and quality of service on other portions of the system" (Roberts,

Record p. 463) is "an unprovable generalization" and Keeley thereupon undertook no more than to "show that if all of the features in connection with these rate adjustments are considered, the conclusion is inescapable that it is impossible to determine the relative rate levels": (Keeley, Record p. 698). The Court will particularly note that no attempt is made by the Railway to show that the general rate level in North Carolina is the same as or lower than the rate level outside the State. Keeley goes on in his testimony to point out the many factors and considerations which must defeat attempt at comparison of general levels.

If the Court should deem admissible the issue proposed by the State, attention is particularly called to the Keeley evidence (commencing Record p. 698) descriptive of rate territories, of the distinction between classified and commodity rates, of the differing methods in different rate territories of employing class and commodity rates, of the effect of competition between carriers (main and branch lines as well as rail and water lines) and between territorial rate systems, of the effect of divisions of through rates between connecting carriers, and his specific mention of partisan omissions, misconstructions and unreliabilities which render the Roberts conclusion valueless. To avoid distraction from the essentials of this case an abstract of the testimony of Keeley (which Railway counsel thought prudent to introduce in rebuttal of Roberts) is printed in an Appendix to this brief.

An illustration, however, is presented of gross distortion of conclusion by neglect of full disclosure on the part of Roberts. He does succeed in showing (Roberts Record pp. 470–487) that coal rates are higher from Nor-

folk and Western producing points to points on the North Carolina branches than to equidistant points on the main line. This looks important—especially when it is borne in mind that 45 to 50% of the revenue traffic of the Railway in North Carolina is coal. But Roberts speaks only of coal delivered on the branches; seven-eighths of the coal handled over the branches goes beyond, to points on the lines of other connecting railroads. These connecting lines must have their share of the through rate. When this interline coal tonnage is included, it appears that the average Norfolk and Western revenue from all coal transported over the North Carolina branches is below the level of revenue from coal which does not leave the main line in Virginia (Keeley, Record p. 708.)

And this Court will be helpless, as Railway counsel confess themselves to be, to figure out with the aid of Roberts' tables the "actual" gross revenue in North Carolina which the State would have the Court substitute for the statutory mileage prorate of gross revenue. The Referee observed that "the State submits no data by which a finding could be made as to how much greater the Southern level is or how much greater the actual revenue is than the amount produced by the use of the statutory formula." Nor could the trial Judge make the necessary specific finding to support his persuasion of greater "actual" revenue. All that the Court can confidently get out of the Roberts-Keeley dispute is a clear understanding of the necessity for the statutory formula of equal mileage prorate of gross revenues. The practical assumption of the statute that the freight money is earned evenly throughout the haul and without regard to local geography or political boundaries, seems inescapable, and the

clear statutory provision that the freight money shall be divided in proportion to mileage in and out of the State is the necessary consequence of the statutory assumption.

But whatever may be said of Roberts' success or failure to show different rate levels in and outside the State and to show the effect on gross revenues within the State of an alleged higher rate level, it seems clear enough that his testimony to facts that could only be relevant if the statute read otherwise than it does, should be given no effect. He testifies in complete disregard of the plain words of the statute which prescribe an equal mileage prorate of interstate revenues.

This Court will realize as did the Referee that the effort of the State to impose upon the Railway in such a case the impossible burden of apportioning gross revenue to the State from each shipment touching the State over its branches otherwise than by the mileage proportion prescribed by the statute amounts to mere obstruction. It would force the taxpayer with just grounds for complaint into a blind alley. The Referee remarked that the practical result of the State's position would be to preclude the taxpayer "from showing that the statute works an unconstitutional result" (Record p. 86). And he added: "The Court will assume that the gross revenue arrived at by the use of the formula is approximately correct until the contrary is shown and no evidence was offered to show that this gross revenue was not approximately correct." The Roberts' attempt to show higher North Carolina rate levels and gross revenues higher than the statutory mileage apportionment is simply unintelligible, was admitted by him to be futile, and is irrelevant to any issue in the case as completely outside the specific mandate of the statute.

Even if the Court should agree with the argument of the State and should incline to discard altogether the statutory formula, still Norfolk and Western gross income in North Carolina would have to be ascertained somehow for taxation. and as the Referee observes (Record pp. 85, 88), the Roberts testimony will not show the amount of it, whatever Mr. Roberts may think about rate levels. The Railway Company is suing the Commissioner in this case to recover a specific sum assessed and paid under an income tax formula which the State in effect admits it cannot defend. The Commissioner and his witness, Roberts, think there may be net income in some amount under an extra-statutory theory. But the assumptions and data on which the Roberts' calculations are based have been shown to be inadequate for any alternative assessment on which to base any tax. Under such circumstances, it is submitted that the Railway should have the judgment it seeks.

III

THE STATE INCOME TAX STATUTE APPLIED TO THE RELEVANT AND EXTABLISHED FACTS OF THE PRESENT CASE VIOLATES THE COMMERCE CLAUSE OF THE FEDERAL CONTITUTION AS IMPOSING A BURDEN UPON INTERSTATE COMMERCE, AND THE DUE PROCESS CLAUSE OF THE FEDERAL CONSTITUTION AS IMPOSING A TAX UPON THE RESULT OF OPERATIONS OUTSIDE AND BEYOND THE REACH OF THE STATE TAXING POWER.

(*Specification of Errors I and II, Record, pp. 844-5*)

It has been suggested to the Referee and to the State Courts, and is suggested again here that there is no dis-

pute between the parties on the principles of law governing the constitutional application of the North Carolina income tax statute. That statute has been before the State Supreme Court and this Court several times. In the last of such cases before the State Supreme Court, Maxwell, Commissioner, *v.* Kent-Coffey Mfg. Co., 204 N. C. 365, 168 S. E. 397, March 15, 1933, the Court, dealing with the application to a manufacturing corporation of the formula for ascertaining net income from intrastate operations, stated the controlling principle:

> "A state may not impose any tax which results in laying a direct burden upon interstate commerce. But a state may, in levying a general income tax, include within the taxable status so much of net income derived from interstate commerce as is properly apportionable to operations and business within the state."

And again the Court said:

> "Conceding that a unitary business may produce an income which must be allocated to two or more states in which its activities are carried on, such a business may not be split up arbitrarily and conventionally in applying the tax laws. It would seem to be necessary that there should be some logical reference to the production of income; the distinction should be founded on a corresponding difference in apportionment of productive capital, investment, or employment, within the unitary business."

Before the Referee and in the State Courts the Railway Company admitted that the business of transporting particular shipments of freight within, into, out of and through the State may be regarded as unitary business in the sense that all of the component factors of expense which go into the carriage of such particular shipments

unite to accomplish their carriage; but that is far from being an admission (as the State persuaded the trial Judge, that "the Railway's business in its entirety is conducted as a unit." The mass of the Railway main line traffic nowhere touches the State, and the admission of the Railway Company has no relation to such traffic. There is therefore no justification for the unqualified assumption of the trial Judge (Record p. 149) that "the business of the defendant Railway Company is unitary in character".

There is no dispute between the parties to this case over the practical necessity for some appropriate unit of measure of interstate business generally for the purpose of State taxation. And the income tax statute here under consideration contains in fact two distinct units of measure: first, the gross revenue of interstate shipments touching the State is apportioned by the unit of distance or mileage of each of such shipments within and outside the State, on the practical assumption that the revenue is evenly earned throughout the haul; and second, the expense of producing the State mileage proportion of gross revenue is under the statute assumed to be ascertainable by application of the system ratio of expenses to State gross revenue. Admitting the impossibility of defending the reality of the second unit of measure, based on the system ratio, the State would overthrow the first or mileage unit of measure of gross revenues.

The mileage unit for allocation of gross revenue produces the gross product of operation within the State in a practical way—in the only practical way—as the witnesses, Roberts and Keeley, demonstrated. The mileage unit of measure gives weight to volume of business, to the dis-

tance hauled in and outside the State, and so ascertains the gross revenue proportioned to that part of the effort expended within the State. The second unit of apportionment, the system ratio, to which the Railway objects, is based on the assumption that the expense of earning each dollar within the State is the same as earning each dollar over the system. But the assumption is contrary to fact where, as in this case, the proofs show that because of the peculiar geographical position of the Railway Company—with nothing but relatively thin branch lines in the State—the volume of main line traffic is from seven to seventy times as heavy as on the branch lines (see Referee's Finding No. 7, Record p. 79), and that operating expenses on the branches is disproportionately heavier because of excessive grades and curves; and the Railway Company, in protection of its constitutional right, is entitled to demonstrate by the available proofs the conclusion which ordinary experience suggests offhand: that the greater the volume of business over a given Railway division or district (for which cost accounting is separately kept—Vaughan, Cross Ex. Record p. 291), the less is the cost per unit of business. In the Courts below the State was driven so far as to argue that expense per unit of business is unaffected by volume of business—an argument which does not comport with practical experience and common sense. Thus, it has gone so far as to say that "relative traffic density" and "volume of business, * * * have no logical or reasonable part in the considerations involved in this case," etc.

If, as appears in this case from the Railway proofs and the admissions of the State's witness, Roberts, the ratio of expenses to earnings on the North Carolina

branches of the Railway is so widely in excess of the system ratio as to result in a showing of income where no income exists or income substantially in excess of the reality, then the use of the system ratio in the statutory formula has been proved to produce a fictitious income, an income necessarily derived from the result of denser operations outside the State.

The practical problem in state taxation of defining the tax object without over-stepping state lines is familiar in many forms and in many cases, and the underlying problem is the same whether the tax be laid on tangible property or intangibles or on income, gross or net, as the following review of some of the leading cases will show:

In Union Tank Line Co. *v.* Wright, 249 U. S. 275, 63 L. Ed. 602, the State of Georgia was seeking to tax as property tank cars which moved under lease over railroads within and outside the State of Georgia. The statutory formula for ascertainment of the tangible property, tank cars, of the taxpayer within the State of Georgia took such proportion of the total number of tank cars owned as the mileage traversed by the cars in Georgia was to the mileage traversed by the cars everywhere. But the formula resulted in a valuation of cars of nearly $300,000.00 as compared with the value of the average number of tank cars within the State of less than $50,000,000.00. Judgment in favor of the State for the tax so erroneously assessed was reversed, with this observation:

> "How to appraise them fairly when the tangibles constitute part of a going concern operating in many states often presents grave difficulties; and absolute accuracy is generally impossible. We have accordingly sustained methods of appraisement producing results approximately correct— for example, the mile-

age basis in case of a telegraph company (Western Union Telegraph Co. *v.* Massachusetts), and the average amount of property habitually brought in and carried out by a car company (American Refrigerator Transit Co. *v.* Hall). But if the plan pursued is arbitrary and the consequent valuation grossly excessive it must be condemned because of conflict with the commerce clause or the Fourteenth Admendment or both. (Citing cases.)

"In the present case the Comptroller General made no effort to assess according to real value or otherwise than upon the ratio which miles of railroad in Georgia over which the cars moved bore to total mileage so traversed in all states. Real values—the essential aim—of property within a state cannot be ascertained with even approximate accuracy by such process; the rule adopted has no necessary relation thereto. During a year two or three cars might pass over every mile of railroad in one state while hundreds constantly employed in another moved over lines of less total length. Fifty-seven was the average number of cars within Georgia during 1913 and each had a 'true' value of $830. Thus the total there subject to taxation amounted to $47,310—the challenged assessment specified $291,196.

"We think plaintiff in error's property was appraised according to an arbitrary method which produced results wholly unreasonable and that to permit enforcement of the proposed tax would deprive it of property without due process of law and also unduly burden interstate commerce."

For comparison with the effort in the foregoing case to ascertain *tangible* property within the State is Southern Ry. Co. *v.* Kentucky, 274 U. S. 76, 71 L. Ed. 934, where a state franchise tax was laid upon the *intangible* property of the Railway Company within the State. The

statutory method was to capitalize the net operating income of the Railway's entire system and assign to Kentucky its mileage proportion of that amount after deduction of tangible property otherwise taxed. The amount of the tax in suit was attributable to the lines of the Southern Railway in Kentucky, a Kentucky subsidiary of the Virginia corporation, Southern Railway Company, but the operating income of the entire system was used for capitalization and division on the statutory mileage basis. The tax was declared invalid, the Supreme Court observing:

> "The operating results of the system compared with those of the Southern Railway Company in Kentucky show that, on the basis of valuation adopted by the State, the average value per mile of the lines of that company is very much less than the average value per mile of the system. If taken separately it is clear that, because of lack of net earnings, no substantial intangible elements of value could reasonably be attributed to the railroad of that company. In order to justify the increases made, there would have to be attributed to these lines large amounts from system earnings.
>
> * * * * * *
>
> And as the direct earnings per mile of the lines of that company are so much less than the average for the system, it is plain that the amount adjudged to have been omitted was arbitrarily excessive and included values of system property beyond the limits of Kentucky."

In Wallace *v.* Hines, Director General, 253 U. S. 66, 64 L. Ed. 782, the North Dakota tax under consideration was a special excise upon the doing of business in the State measured by the capital invested in the business in the State. The Tax Commissioner ascertained the

value of the total property of the railroad by the total value of its stocks and bonds and assessed to North Dakota the proportion of that value that the main track mileage in North Dakota bore to the main track mileage of the whole line. Condemning this method as incorrect for the proofs in that particular case, the Court observed:

> "But on the allegations of the bill, which is all that we have before us, the circumstances are such as to make that mode of assessment indefensible. North Dakota is a state of plains, very different from the other states, and the cost of the roads there was much less than it was in mountainous regions that the roads had to traverse. The State is mainly agricultural. Its markets are outside its boundaries and most of the distributing centers from which it purchases also are outside. It naturally follows that the great and very valuable terminals of the roads are in other states. So looking only to the physical track the injustice of assuming the value to be evenly distributed according to main track mileage is plain."

For this and other reasons this Court thought a showing had been made of "an unwarranted interference with interstate commerce and a taking of property without due process of law."

In cases of the class examined, including the present case, the statutory formula is not invalid on its face without regard to the particular circumstances of the taxpayer. Ordinarily the taxpayer must, as here, show that the statutory formula results in the taxation of property, income, franchise or what not, which either has no existence or does not exist within the State in the proportion sought to be taxed. And so here the Railway Company, as taxpayer, recognized and undertook the burden of show-

ing affirmatively and convinced the Referee that the so-called income produced by the system ratio formula does not exist at all. Clearly enough the Railway case must be proved specifically, as a pair of important recently decided cases shows.

In Underwood Typewriter Co. *v.* Chamberlain, 254 U. S. 113, 65 L. Ed. 165, a Connecticut tax was measured by the net profits earned within the State of a foreign manufacturing and trading corporation, the amount of such profits taxable in the State being ascertained by reference to the proportion between the value of the corporation's real and tangible personal property within the State and all its real and tangible personal property. The tax levy was upheld and the statutory formula approved on failure of the taxpayer to demonstrate that the statutory apportionment was inherently arbitrary or produced an unreasonable result in its application to the taxpayer. The Kent-Coffey case, cited above, from the Supreme Court of North Carolina (168 S. E. 397) is another instance wherein the taxpayer failed to sustain his burden of proof. On the other hand, in the Hans Rees case, 283 U. S. 123, 75 L. Ed. 879, cited above, the taxpayer successfully assumed and carried the burden of showing that the application of the North Carolina income tax formula to the business of a manufacturing and trading corporation was arbitrary and unreasonable and in violation of the due process and equal protection clauses of the Fourteenth Amendment.

The Railway Company in the present case assumed this burden and recognizes one principal issue here and that is whether the system ratio of expenses to earnings approximates or is even relevant to ascertainment of net

income earned within the State in the singular circumstances of this Railway Company.

Doubtless the invocation of the system ratio offers an easy, convenient way of solving the admittedly difficult problem of ascertaining and apportioning the results of a business conducted without regard to political boundaries; but as this Court said in the case of Stewart Dry Goods Co. *v.* Lewis, 294 U. S. 550, 79 L. Ed. 1054:

> "We are told that the gross sales tax in question is in truth a rough and ready method of taxing gains under the guise of taxing sales; that it is less complicated and more convenient of administration than an income tax; and Kentucky for these reasons is at liberty to choose this form, and to ignore the consequent inequalities of burden in the interest of ease of administration. The argument is in essence that it is difficult to be just and easy to be arbitrary. If the Commonwealth desires to tax incomes it must take the trouble equitably to distribute the burden of the impost. Gross inequalities may not be ignored for the sake of ease of collection."

On the facts and on the law of this case the Railway Company seems plainly entitled to the judgment it seeks —a final judgment based upon the only specific findings made on the record.

Respectfully submitted,

THEODORE W. REATH
F. M. RIVINUS
W. W. COXE
MURRAY ALLEN
BURTON CRAIGE

Counsel for Norfolk and Western Railway Company

January, 1936

APPENDIX

The evidence of defendant's witness, Keeley, is a complete refutation of the assertion that the rates on the Railway's North Carolina branches are on a higher level than on other portions of the system; establishes that such assertion is an unprovable generalization; and disproves the argumentative opinions, conclusions, and theories of witness Roberts, that the Railway's revenue yield from the haul or portion thereof on said branches is relatively greater than on other portions of the system.

We may here review the Keeley testimony:

1. Considered first from the standpoint of rate level alone, the said assertion concerning said level is unprovable:

(a) Because the rate systems are different in the different rate territories, as for example:

In Southern Classification territory the class rates are comparatively high. But in that territory very little carload freight and not all less-than-carload freight moves on these class rates; the bulk of the carload freight and a large part of the less-than-carload freight in that territory moving on comparatively low commodity rates which have been provided in great numbers by the Southern carriers for substantially all articles that move in large volume. Many of these commodity rates are on as low a level or lower than the level of class or commodity rates applicable on the same article in Official territory. The I. C. C. (100 I. C. C. 513, 533) estimates that only 16.5% of the revenue of Southern carriers is from class rate traffic.

In Official territory, the system of rate-making is just the opposite. There class rates are used for movement

of a large volume of freight on which commodity rates would be used in the South, and commodity rates are not so frequent as in the South.

Keeley, Record pp. 702–707; 709–714; 731–738.

(b) Because the classification ratings in the two territories vary widely. A particular article may be assigned to first class in one territory, and to second, third or fourth class in the other. The relations of the classes differ in the two territories, sixth class (for example) in one being 40% of first class and 27½% in the other. Keeley, Record pp. 702–706.

It may be appropriate to r a decision by the Interstate Commerce Commission April 10, 1933, in Investigation and Suspension Docket No. 3660, Rates on Bristol and Norton Lines of Norfolk and Western Railway, 192 I. C. C. 315, Wherein the Commission, among other things, was considering the relative levels of class rates in Official Classification territory as contrasted with such levels in Southern Classification territory. We take the liberty of herewith quoting from Sheet 9 of the Commission's mimeographed report of April 10, 1933, its following comments on said relative levels of class rates:

"The marked difference between the class-rate structure in Official territory and the class-rate structures within Southern territory and between the two territories presents an exceedingly troublesome and difficult rate problem. * * *

"As we have found, class rates in the two territories perform to a considerable extent different functions. In Official territory they have been applied to the movement of carload traffic in volume to a much greater degree than in the South. On the other hand, commodity rates in

the South are often on a relatively lower level in comparison with class rates, and sometimes on an absolutely lower level than they are in the North. It is these facts which have made any attempt at harmonizing the class-rate structures of the two territories so difficult, * * *."

(c) By selecting certain traffic originating in one territory and going in a given direction, one conclusion (as to rate levels) can be justified—but just the opposite conclusion (as to such levels) would be drawn by selecting other traffic originating in another territory and going in another direction, as exemplified by the contrast of the C. F. A. origin traffic selected by Roberts (Record pp. 491–497, 503–533) with the Trunk Line origin traffic selected by Keeley (Exhibit 3, Record pp. 746–749) and the northbound North Carolina traffic used by Keeley in his Exhibits 10–14, inclusive, Record pp. 765–777.

(d) North Carolina intrastate class rates were until 1930 lower than the interstate rates from Virginia points to Southern territory (Keeley, Record pp. 719–720) and lower than Virginia intrastate class rates (Keeley, Record p. 758, Exhibit 8, 729–30); and intrastate rates generally (both class and commodity) on the North Carolina portion of Winston and Durham branches are lower than intrastate rates on the Virginia portion thereof (Keeley, Record pp. 728–29, Exhibit 7, pp. 754 et seq.).

2. Considered from the standpoint of both rate level and revenue yield, the general level of class rates in Southern Classification territory is commonly thought to be higher than that in Official territory, but as aforesaid the revenue from all class-rate traffic in Southern territory and between Southern and Official territories is only one-sixth of the total carrier revenue from freight traffic. And

by no means all of the class rates in Southern territory are higher than those on the same articles in Official territory. Commodity rates move the bulk of the traffic in Southern territory and between Southern and Official territory, and the Railway's revenue from the North Carolina branch haul of commodity rated traffic (particularly northbound) is relatively less or not higher than its revenue from the haul of such traffic on the main line or north thereof.

Innumerable instances can be cited in support of the foregoing statement. Some of them are:

(a) Manufactured tobacco, cotton and knitting factory products, forest products and furniture are the four important productions in North Carolina and constitute ten-thirteenths of the value of the principal products of the industries of North Carolina (Keeley, Exhibit 9, Record p. 764). All of these move on commodity rates and the Railway's revenue from the branch haul thereof is relatively lower than from the haul on the main line or north thereof (Keeley, Record pp. 731–738, Exhibits 10–14, inclusive, pp. 765–777).

(b) Class rates from various Trunk Line and New England territory origins to Winston-Salem are relatively lower than the class rates from the same origins to Roanoke (Keeley, Record pp. 711–713, Exhibit 3, Record p. 746), and the revenue from the branch portion of the haul is relatively lower than from the portion of the haul on the main line or north thereof.

(c) The class rates covered by the K-2 scale applied to Official territory, described by Keeley, Record pp. 715–719, are not higher in Southern than in Official territory, and the revenue from the branch portion of the haul is not higher than on the main line and north thereof.

(d) Plaster rates are relatively lower on the North Carolina branches than on the main line and the revenues from the branch portion of the haul are relatively lower than the main line portion (Keeley, Record p. 722).

(e) The revenues from the commodity rates on Keeley, Exhibit 6, are relatively lower for the branch haul than for the main line haul or for the portion of the haul on the main line (Keeley, Record p. 723).

(f) The North Carolina intrastate class rates and commodity rates on the branches are lower than the Virginia intrastate class and commodity rates on the branches and the revenue from the North Carolina intrastate hauls is relatively lower than the revenue from the Virginia intrastate hauls (Keeley, Record pp. 728–729, Exhibit 7, Record p. 754).

3. The freight rates on the Railway's North Carolina branches are not made to respect the higher operating costs on those branches:

(a) These branches all lie in Southern Classification territory with, and have the same level of rates as, the competing main lines of the Southern, Seaboard, Atlantic Coast Line and Norfolk Southern Railways, and these competing main lines and the rates thereon are the principal factors that fix the branch rates. Other influences were the "long and short haul" clause of the Fourth Section of the I. C. Act and the various horizontal rate advances in the respective rate territories (Keeley, Record pp. 701–2).

(b) Many instances can be presented and numerous instances are presented by the witness, Keeley, showing

that the rates for the branch haul were relatively lower than, or not higher than, the rates for the haul on the main line or north thereof, among which are:

Keeley, Record pp. 711–714, Ex. 3, Record pp. 746–749. Various class rates from Trunk Line and New England territory points relatively lower to Winston-Salem than to points on main line and north thereof.

Keeley, Record pp. 721–722. Cement and lime rates uniform.

Keeley, Record p. 722. Plaster rates on Carolina branches relatively lower than on main line.

Keeley, Record p. 723, Ex. 6, Record p. 752.

Various commodity rates (stone and lumber particularly) lower on Carolina branches than on main line.

Keeley, Record pp. 728–729, Ex. 7, Record p. 754. Carolina intrastate rates on branches lower than Virginia intrastate rates thereon.

Keeley, Record pp. 731–734, Ex. 10, Record p. 765. Manufactured tobacco rate relatively lower on Carolina branches than north thereof.

Keeley, Record p. 734, Ex. 11, Record p. 767. Cotton and knitting product rates generally relatively lower on Carolina branches than north thereof.

Keeley, Record pp. 735–737, Ex. 12 and 13, Record pp. 769–70. Forest products rates relatively lower on Carolina branches than north thereof.

Keeley, Record pp. 737–738, Ex. 14, Record pp. 771–777. Furniture rates relatively lower on Carolina branches than north thereof.

The last four items alone constitute ten-thirteenths of the value of the principal products of the industries in

North Carolina as reflected by Keeley, Exhibit 9, Record p. 764.

4. Even if the level of the rates on the North Carolina branches were higher than that on the main line and north thereof, this does not mean the revenue received by the Railway for the branch portion of the haul is greater than for the portion of the haul on the main line and north thereof. On the contrary, by reason of the divisions the Railway is compelled to make with connecting carriers, the branch portion of the revenue is generally less than the main line portion thereof.

(a) About 75% of the Railway's business over the Carolina branches is received from and/or destined to connecting lines, to whom it has to concede heavy divisions (Keeley, Record pp. 702; 715 et seq.; 725–726, Exhibits 2 and 4, Record pp. 744: 750).

(b) Coal alone constitutes about half of the Railway's North Carolina business, but as shown by Keeley, Record pp. 707–709, and Exhibit 2 (Record p. 744), its North Carolina revenue therefrom is less per ton than the revenue per ton on the main line.

(c) The divisional situation with respect to coal obtains with respect to merchandise other than coal (Keeley, Record pp. 715 et seq., 725–726).

5. Even if the rates on the North Carolina branches were on a higher level generally than on the main line, it does not follow that the Railway's revenue from its branch hauls is, even in the absence of divisions with connecting carriers, greater than its revenues from its haul of the same articles on the main line or north thereof, because the actual traffic hauled may move on rates, the branch por-

tions of which are lower or not higher than on the portion of the railway north thereof; and hence innumerable instances can be cited in which the revenue from the branch haul is less than the haul on the main line or north thereof. For example, see the illustrations referred to under subdivision 2, second paragraph *supra*.